Elgin
the investor's choice

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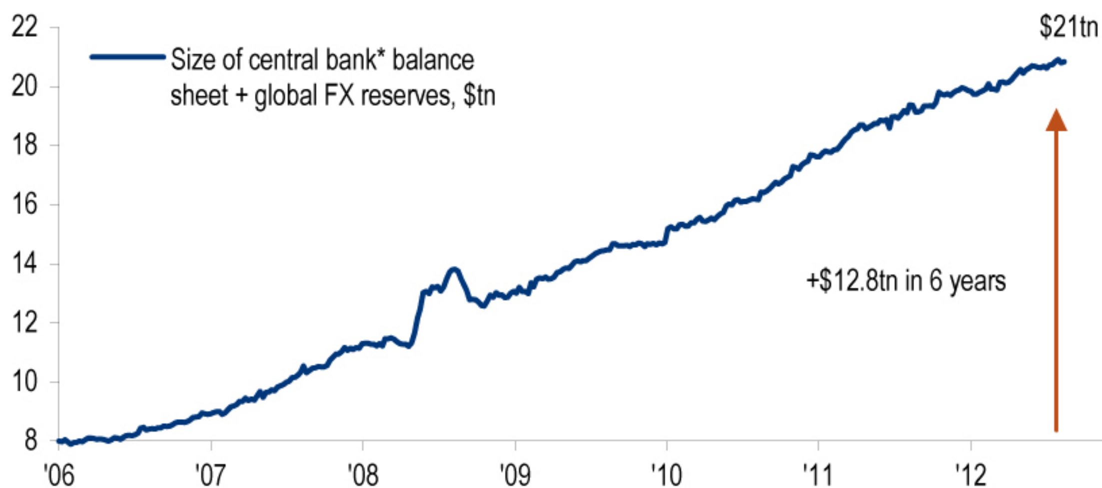
Monthly Commentary 4th February 2013

Markets were off to the races in January. Developed markets have been stronger than emerging ones (+5% vs +1.3%). Higher-rated bonds got hammered, while lower-rated ones did much better. Led with a 6% gain in oil, commodities were also off to a good start. In currencies the Euro was the big winner as it gained 3% vs USD and more than 6% vs GBP).

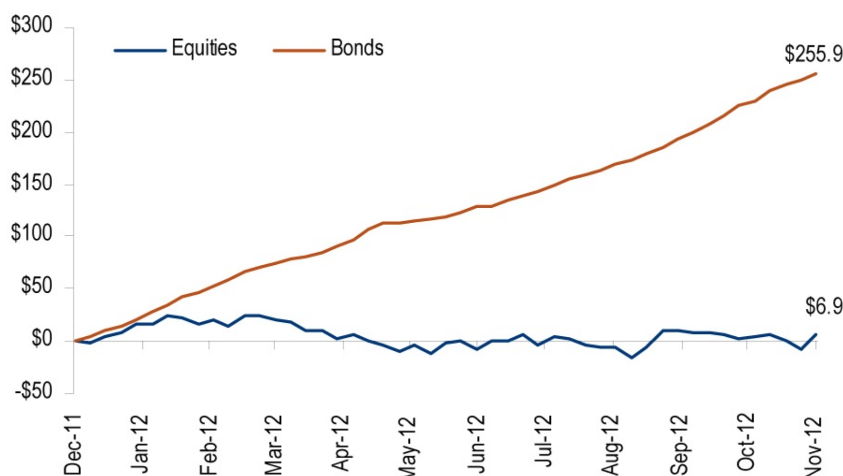
It is indeed easy to make a bullish case for risk assets, especially equities.

The first chart below shows a $12.8 Trillion increase of Central Bank balance sheets since 2006. Part of this amazing stimulus has found its way to risk assets, and there is every indication that it will continue, despite warnings from the likes of Axel Weber (Chairman of UBS and former chairman of Germany's Bundesbank) that "We're living a better life now at the expense of future generations".



* ECB + Fed + BoJ + BoE + SNB. Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

As widely reported in the press recently, if the "great rotation" from bonds to equities starts in earnest, it could provide a huge boost to equities. The chart below shows the cumulative flows in the US alone into equities and bonds since 2006. There are indications that this trend has started to reverse.



Source: EPFR Global, BofA Merrill Lynch Global Equity Strategy

What are the main worries in investors' minds?

One could argue that investor sentiment – always an important ingredient in equity markets – is becoming a bit too frothy and that we could be nearing a top.

Another worry is that the only reason equities are doing well is because of the monetary stimulus from Central Banks. As Perma-Bear David Rosenberg recently wrote,

"*The last cycle was built on artificial prosperity propelled by financial creativity on Wall Street and this cycle is being built on an abnormal era of central bank market manipulation*".

As for Europe, the FT recently noted that "*The continent still boasts precious little growth, chronic unemployment and a pile of public debt. The banks are in far from rude health, and there are political battles aplenty ahead*".

Finally on the negative side of the ledger, the "Fiscal Cliff" issues are far from being resolved. The fiscal-cliff deal may have kicked the can down the road, but it:

• Does nothing to raise the debt ceiling, so we can look forward to another round of political finger pointing and arguing;

• Does nothing to address stubbornly high levels of unemployment that have left 12 million Americans out of work;

• Does nothing to slow down the growth of our deficit or to reduce our $16 trillion national debt.

That said, the negative case for the stock market is always more articulate than the bullish case. It is always more rational and sounds more compelling, because a negative case is built on now, whereas the market is looking ahead.

For investment strategy, we shall give the bulls the benefit for the time being, and as we have been doing for a while, start favouring quality long-only equity funds and ETF's. This will increase portfolio risk, as any correction will negatively affect portfolios. Still, the case for improving equity returns is strong enough that we are comfortable raising portfolio risk in order to reap the rewards.